PART II

ITEM 5. MARKET FOR ALLEGIANCE TELECOM'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

Market Information. Our common stock is currently listed on the Nasdaq National Market Our ticker symbol is "ALGX " We completed the initial public offering of our common stock in July 1998 Prior to July 1, 1998, no established public trading market for the common stock existed The following table sets forth on a per share basis, the high and low sale prices per share for our common stock as reported on the Nasdaq National Market for the periods indicated

	HIGH	LOW
Year ended December 31, 2001		
First quarter	$40 0000	$12 4375
Second quarter	22 1000	8 5000
Third quarter	15 8000	2 8000
Fourth quarter	9 8500	2 7400
Year ended December 31, 2002		
First quarter	9 6000	1 8800
Second quarter	2 9100	0 8500
Third quarter	1 7700	0 5200
Fourth quarter	2 0900	0 5800

Please see the above discussion under "Risk Factors—If we are delisted from Nasdaq, the liquidity and market price of our common stock may be adversely affected "

Stockholders. There were 296 owners of record of Allegiance common stock as of March 26, 2003 This number excludes stockholders whose stock is held in nominee or street name by brokers and we believe that we have a significantly larger number of beneficial holders of common stock On March 26, 2003, our common stock on the Nasdaq National Market closed at $0.34.

Dividends. We have never paid any cash dividends and we do not anticipate paying any cash dividends in the foreseeable future Any future determination to pay dividends will be at the discretion of our board of directors and will be dependent upon then existing conditions, including our financial condition, results of operations, contractual restrictions, capital requirements, business prospects, and other factors our board of directors deems relevant In addition, our current financing arrangements effectively prohibit us from paying cash dividends for the foreseeable future Our senior credit facilities prohibit us from paying cash dividends on our common stock and our indentures limit our ability to pay cash dividends on our common stock

Recent Sales of Unregistered Securities. On August 24, 2001, we acquired Coast to Coast Telecommunications, Inc through a subsidiary merger As part of additional consideration required under the terms of the merger agreement and a settlement of post-closing issues, we issued 218,032 shares and 312,500 shares of our common stock to the former owner of Coast to Coast Telecommunications, Inc on February 1, 2002 and December 3, 2002, respectively On November 30, 2000, we acquired Jump Net, Inc through a subsidiary merger As part of additional consideration required under the terms of the merger agreement, we issued 24,936 and 3,258 shares of our common stock to the former owners of Jump Net, Inc on January 28, 2002 and November 8, 2002, respectively The shares issued in these transactions are subject to transfer restrictions imposed by the securities laws which are noted on the applicable stock certificates These transactions were exempt from registration under the Securities Act pursuant to Section 4(2) of that Act

ITEM 6. SELECTED FINANCIAL DATA

Selected Financial Data (dollars in thousands, except share and per share information)

The selected consolidated financial data presented below as of and for the years ended December 31, 2002, 2001, 2000, 1999 and 1998, were derived from our audited consolidated financial statements and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and audited consolidated financial statements and the notes thereto contained elsewhere in this report The historical selected financial data may not be indicative of future performance and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Risk Factors" in this report

	As of December 31,				
Balance Sheet Data	**2002**	**2001**	**2000**	**1999**	**1998**
Cash and cash equivalents	$253,311	$374,084	$396,103	$502,234	$262,502
Short-term investments	30,955	25,232	261,856	23,783	143,390
Short-term investments, restricted(1)	—	—	12,952	25,518	25,543
Working capital(2)(3)	(288,880)	426,932	618,255	484,458	367,492
Property and equipment, net of accumulated depreciation	924,106	1,016,250	744,903	377,413	144,860
Long-term investments, restricted(1)	881	954	829	13,232	36,699
Total assets	1,441,218	1,774,843	1,668,839	1,033,875	637,874
Long-term debt(3)	639,691	1,013,184	566,312	514,432	471,652
Redeemable warrants	—	—	—	—	8,634
Stockholders' equity	43,724	608,076	958,485	443,616	110,430

Statement of Operations Data:	**Year Ended December 31, 2002**	**Year Ended December 31, 2001**	**Year Ended December 31, 2000**	**Year Ended December 31, 1999**	**Year Ended December 31, 1998**
Revenues	$770,982	$516,888	$285,227	$99,061	$9,786
Network expenses	404,444	251,734	150,718	62,542	9,529
Selling, general and administrative expenses	438,158	377,387	252,368	140,745	46,089
Depreciation and amortization expense	282,143	256,685	130,826	55,822	9,003
Management ownership allocation charge	—	175	6,480	18,789	167,312
Non-cash deferred compensation expense	2,726	4,126	10,127	7,851	5,307
Goodwill impairment charge	114,722	—	—	—	—
Loss from operations	(471,211)	(373,219)	(265,292)	(186,688)	(227,454)
Interest income	6,594	15,665	56,969	31,354	19,918
Interest expense	(108,053)	(74,259)	(69,244)	(59,404)	(38,952)
Net loss	(572,670)	(431,813)	(277,567)	(214,738)	(246,488)
Accretion of redeemable preferred stock and warrant values	—	—	—	(130)	(11,972)
Net loss applicable to common stock	$(572,670)	$(431,813)	$(277,567)	$(214,868)	$(258,460)
Net loss per share, basic and diluted(4)	$(4 88)	$(3 82)	$(2 58)	$(2 37)	$(7.02)

Statement of Operations Data.	Year Ended December 31, 2002	Year Ended December 31, 2001	Year Ended December 31, 2000	Year Ended December 31, 1999	Year Ended December 31, 1998
Weighted average number of shares outstanding, basic and diluted(4)	117,349,242	113,115,871	107,773,112	90,725,712	36,825,519
Other Financial Data					
Net cash used in operating activities	(68,288)	(215,636)	(102,552)	(111,483)	(20,697)
Net cash used in investing activities	(169,842)	(157,884)	(716,708)	(152,217)	(315,743)
Net cash provided by financing activities	117,357	351,501	713,129	503,432	593,216
Capital expenditures	(129,896)	(364,396)	(430,817)	(257,966)	(110,741)
Gross margin(5)	47 5%	51 3%	47 2%	36 9%	2 6%

(1) Reflects the purchase of U S government securities which were placed in a pledge account to fund the first three years' interest payments on the $12\frac{7}{8}\%$ senior notes due 2008 The first semi-annual installment was paid in November 1998 The securities are stated at their accreted value, which approximates fair value, and are classified as either short-term or long-term based upon their respective maturity dates Long-term investments also includes certificates of deposit held as collateral for letters of credit issued on our behalf

(2) Working capital was calculated as total current assets, less restricted short-term investments, less total current liabilities

(3) Reflects the reclassification of long-term debt to current portion of long-term debt at December 31, 2002 to reflect the effect of the reduction in long-term debt as required under the interim amendment dated November 27, 2002 to our senior credit agreement

(4) All periods presented reflect a three-for-two stock split effected on February 28, 2000

(5) Gross margin was calculated as revenues less network expenses, divided by revenues See "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion of the components included in revenues and network expenses

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

We are a facilities-based national local exchange carrier that provides telecommunications services to business, government and other institutional users in major metropolitan areas across the United States We offer an integrated set of telecommunications products and services including local, long distance, Internet, data colocation, web hosting and customer premise equipment sales and maintenance services Our principal competitors are the incumbent local exchange carriers (also known in the industry as the "ILECs"), as well as long distance carriers and other integrated communications providers

We began operations in late 1997 with an objective to grow rapidly and establish our company as a national communications provider covering the major metropolitan areas across the United States By the end of 2001, we had completed the network rollout in our 36 targeted markets Atlanta, Austin, Baltimore, Boston, Chicago, Cleveland, Dallas, Denver, Detroit, Fort Lauderdale, Fort Worth, Houston, Long Island, Los Angeles, Miami, Minneapolis/St Paul, New York, Northern New Jersey, Oakland, Ontario/Riverside, CA, Orange County, Philadelphia, Phoenix, Pittsburgh, Portland, Sacramento, St Louis, San Antonio, San Diego, San Francisco, San Jose, Seattle, Tampa, Washington, D C , West Palm Beach/Boca Raton and White Plains, NY

We use multiple technologies in our network and a mixture of leased and owned facilities at the edge of the communications network in order to most effectively serve our customer base where it is physically located Management's focus is on providing facilities-based services, and we generally provide services via resale on a limited basis We do not use what is known as the unbundled network element platform ("UNE-P") to deliver services, except in a small number of sales where our facilities-based services would not be practicable or as an interim measure until the resold services can be converted to facilities-based services UNE-P is a method where a carrier can lease all elements of a service from an incumbent local carrier, including the switching equipment. As of December 31, 2002, over 95% of our lines in service were provided over our own network facilities The services that we provide over our own network generate higher margins than services provided by other carriers that are resold by us Consistent with our facilities-based approach, we install voice and data aggregation and switching equipment in our own premises We also install voice and data aggregation equipment in the central offices or "hubs" of the existing local incumbent carrier's networks, also known as colocation This voice and data aggregation equipment connects directly to customers through the "local loop," which consists of the existing copper wire and fiber running from the central offices to each customer location The local loop is owned by the incumbent carriers but can be leased by competitive carriers under the terms of the Telecommunications Act of 1996 Our local loop presence provides us with a flexible platform for delivering traditional voice and data access services to end-user customers We connect our colocations to our main switching center in each market by either leasing additional network elements from the incumbent carriers and other providers on a short-term basis or by using dedicated fiber on a long-term basis We have increasingly focused on dedicated fiber because of the growth of our customer base and traffic volume as well as its reliability

As we have developed our local networks to service end-user customers, we have also attempted to capitalize on our expertise and investment at the edge of the network and in our intercity Internet backbone We have leveraged our network assets by providing network solutions to other service providers, primarily the leading national and regional Internet providers These national network providers have end-user customers but do not generally have the facilities and expertise to directly access these customers in all relevant geographic areas through the local loop Many of these providers focus on the residential Internet access market

We devoted most of 2002 to completing the buildout of our networks in our markets by building out colocations, completing dedicated local fiber transport facilities and upgrading and transitioning our customers to our nationwide, Tier 1 Internet backbone In the third quarter of 2002, as we substantially completed our nationwide network as well as the implementation of our next generation intercity Internet backbone, we entered a slower operational growth phase, with significantly lower capital expenditures Consistent with our senior credit facilities covenants, we shifted our focus in the second half of 2002 from high revenue growth to profitability and positive cash flow As we change our focus in this manner, we have reduced our sales and network expansion related headcount, we have eliminated and will continue to eliminate less profitable products and services, and we have and will continue to optimize the utilization of our existing network assets Our 2002 results reflect the impact of this reorientation of our operations and we anticipate that our 2003 results will also reflect this change in focus, as we continue to optimize our network, our customer base and the composition of our workforce

The following discussion and analysis relates to our financial condition and results of operations for the years ended December 31, 2002, 2001, and 2000 This information should be read in conjunction with the consolidated financial statements and notes to those financial statements contained in this Form 10-K, as well as the section captioned "Risk Factors" in this Form 10-K

RESULTS OF OPERATIONS

Revenues

Year Ended December 31, 2002 compared with Year Ended December 31, 2001

For the years ended December 31, 2002 and 2001, we generated revenues of approximately $771 0 million and $516 9 million, respectively This 49 2% increase in revenues is attributable to an increase in the number of customers and services and products sold (including through acquisitions and the addition of additional markets during the year ended December 31, 2001), specifically, our revenue growth during the year ended December 31, 2002 was enhanced by our acquisitions from WorldCom, Inc of (a) the Internet backbone assets of Intermedia Business Internet in December 2001 and (b) the customer premise equipment sales and customer premise equipment maintenance businesses, also known as Shared Technologies Fairchild, in June 2002 During the year ended December 31, 2002, our revenue growth was impacted by (a) decreases in interconnection revenues due to dispute settlements and regulatory rate reductions, (b) decreases in our web hosting revenues as we continued to curtail that product line, (c) decreases in our Internet access revenues associated with our ongoing integration of the backbone assets of Intermedia Business Internet (which we purchased from WorldCom in December 2001), (d) churn and (e) decreases in our sales force Our focus has shifted from high revenue growth to profitability and we do not anticipate the level of revenue growth that we have experienced in the past Future revenue growth will depend on our ability to add new customers in a competitive market place, retain existing customers and manage churn, increase customer usage and sell additional services to our existing customers We believe that managing our churn is one of our biggest challenges The amount of churn directly impacts our revenues See the discussion of line churn under the caption "Liquidity and Capital Resources" below

Local voice service revenues for the years ended December 31, 2002 and 2001 were $369.1 million and $326 2 million, respectively Local voice service revenues as a percent of total revenues has decreased from approximately 63% for the year ended December 31, 2001 to approximately 48% for the year ended December 31, 2002 Local voice service revenues consisted of

- the monthly recurring charge for basic local voice service,
- usage-based charges to end-users for local and toll calls in certain markets,
- charges for services such as call waiting and call forwarding,

- certain non-recurring charges, such as set-up charges, and

- interconnection revenues from switched access charges to long distance carriers and reciprocal compensation charges to other local carriers

We expect local voice service revenues to continue to decrease from period to period as a percent of total revenues, as a result of our increasing focus on integrated voice, data and customer premise equipment sales and services, the resolution of certain regulatory disputes and uncertainties and lower rates for interconnection revenues as mandated by our negotiated agreements with carriers, the FCC and certain states Specifically, we expect that switched access revenues and reciprocal compensation revenues will continue to decrease See the discussion under "Risk Factors," which contains a detailed discussion of the risks and uncertainties associated with our local voice revenues

Long distance service revenues for the years ended December 31, 2002 and 2001 were $47 6 million and $29 5 million, respectively Long distance service revenues as a percent of total revenues has remained consistent at approximately 6% for the years ended December 31, 2002 and 2001 We expect that our long distance revenues will increase in absolute dollars over time

Data revenues, including revenues generated from Internet access, web hosting and high-speed data services, for the years ended December 31, 2002 and 2001 were $275 6 million and $161 2 million, respectively Data revenues as a percent of total revenues has increased from approximately 31% for the year ended December 31, 2001 to approximately 36% for the year ended December 31, 2002 We expect data revenues to continue to increase on an absolute basis despite the negative trends discussed below, (a) as we expand our data offerings to existing local and long distance voice customers and to customers of our equipment sales and maintenance businesses, (b) as we increase our offerings of integrated services that combine voice and data services and (c) as more small and medium-sized businesses turn to the Internet to enhance their productivity We also believe that the continuing evolution of communications networks will promote the integration of voice and data services over the same facilities, thereby further increasing the availability of data offerings

The rate of growth in our data revenues has been affected by negative trends We believe that the demand for high-end web hosting services has decreased in response to a general economic slowdown Moreover, an over capacity of data center space has decreased prices for these high-end services High-end services include dedicated hosting services where we provide the customer with a dedicated computer server in our data centers and colocation services where we provide data center space and services for a customer who locates its own computer server on our premises We believe that the general economic slowdown has caused a deterioration in our shared hosting business as well

Similarly, the demand for services we offer to network service providers who provide dial-up Internet access services is also experiencing the effects of over capacity and decreased demand The resulting financial hardship has lessened the number of these types of network service providers During 2000, we signed a long-term contract to provide an integrated network solution and certain services to Genuity Solutions Inc , a network services provider and operator of a nationwide Internet network Our contract was established specifically to support Genuity's customer contracts, including that with America Online The contract term expires on December 31, 2006 In August 2002, we amended the agreement to, among other things, increase Genuity's commitment and change the payment schedule Under the amended agreement, Genuity committed to pay us an aggregate of $563 0 million over the term of the contract, subject to our performance under and the other terms and conditions of the contract. The contract contains specific provisions that allows Genuity to decrease its purchase commitment, including but not limited to, Genuity experiencing a business downturn The agreement also provides that if we receive a going concern qualification or experience an event of default as defined under our senior credit agreement, (a) Genuity may exercise an option to purchase all of the dedicated assets and infrastructure used by us to provide the integrated network solution to Genuity and (b) Genuity would still be required to continue to purchase certain services from us for the remainder of the term of the agreement If Genuity exercises its option, Genuity would be required to pay (1) for the dedicated assets, the remaining undepreciated value of the dedicated assets (as reflected on our books at the time of exercise of the option) and (2) for the certain services, the remaining overall value of the agreement less the amounts paid to purchase the dedicated assets and infrastructure

For the years ended December 31, 2002 and 2001, revenues from the Genuity contract were $90 3 million and $46 8 million, respectively Genuity accounted for 12% and 9% of our total revenues for the years ended December 31, 2002 and 2001, respectively, and 33% and 29% of our data revenues for the same periods Our Integrated Network Solution Purchase Agreement with Genuity has recently been assigned by Genuity to Level 3 Communications, Inc We anticipate that Level 3 will continue to be our largest customer for the foreseeable future We have recently received letters from Level 3 claiming, among other things, that we failed to meet certain performance warranties, that such failures were continuing, that Level 3 was offsetting its next purchase price payment by approximately $18 8 million, and that if such alleged failures continued, Level 3 could terminate the contract We do not believe that we failed to meet the performance warranties alleged by Level 3 and have asked Level 3 to investigate the facts surrounding these issues Level 3 has since withdrawn these letters and acknowledges that additional investigation is necessary to determine whether we failed to meet those performance warranties, but Level 3, however, reserved its rights to pursue any claims under our contract Our failure to meet the performance warranties under this contract may allow Level 3 to offset future payments to us and, if such failure continued for an extended period of time, Level 3 could terminate the contract The resulting reduction in revenue and/or loss of this customer contract would have a material adverse effect on our business We are negotiating with Level 3 to change certain service level warranties, remedies and penalties under this contract that would increase our performance requirements in exchange for less punative remedies and penalties and a relinquishment of all claims for prior penalties and credits relating to our performance We can provide no assurances that these negotiations will be successfully concluded

Notwithstanding these trends and uncertainties, we expect continued demand by small and medium sized business customers for dedicated access to the Internet and integrated services Indeed, our Integrated Access Service which delivers high-speed, "always on" Internet access and allows multiple voice, data and Internet combinations over a single access loop remains our fastest growing product offering. During the year ended December 31, 2002, Integrated Access Service represented approximately 43% of our net additional lines in service for the year We believe that line churn rates (the rate at which customers disconnect their lines) for this type of service is lower than that of our local voice service One of the challenges we face in this area is ongoing network efficiency and service delivery improvements to retain the competitive advantages of this service offering

During the year ended December 31, 2002, we acquired substantially all of the assets and assumed certain liabilities of the customer premise equipment sales and customer premise equipment maintenance businesses, also known as Shared Technologies Fairchild, from WorldCom We believe the acquisition of these businesses enhances our ability to offer additional services to our customers Further, we believe this acquisition presents an opportunity to cross-sell our other integrated telecommunications services to the customers of these acquired businesses Customer premise equipment sales and maintenance revenues were $78 7 million for the year ended December 31, 2002 Customer premise equipment sales and maintenance revenues as a percent of total revenues is approximately 10% for the year ended December 31, 2002

As part of our overall business strategy, we have had discussions and plan to have discussions concerning potential acquisitions of providers of telecommunications and Internet services We believe that investment capital for many of these providers is either unavailable or very difficult to obtain and, as a result, has created some attractive opportunities for us to acquire customers and businesses through acquisitions While there can be no assurances that we can take advantage of these opportunities, our ability to take advantage of these opportunities, is dependent on a number of factors, including the market value and liquidity of our common stock and access to capital (because we use our stock and cash as consideration for acquisitions) and limitations in our financing agreements

Year Ended December 31, 2001 compared with Year Ended December 31, 2000

For the years ended December 31, 2001 and 2000, we generated revenues of approximately $516 9 million and $285 2 million, respectively The increase in revenues is attributable to an increase in the number of customers (including through acquisitions)

Local voice service revenues for the years ended December 31, 2001 and 2000 were $326 2 million and $208 8 million, respectively Local voice service revenues as a percent of total revenues has decreased from approximately 73% for the year ended December 31, 2000 to approximately 63% for the year ended December 31, 2001

Long distance service revenues for the years ended December 31, 2001 and 2000 were $29 5 million and $11 2 million, respectively Long distance service revenues as a percent of total revenues has increased from approximately 4% for the year ended December 31, 2000 to approximately 6% for the year ended December 31, 2001

Data revenues, including revenues generated from Internet access, web hosting and high-speed data services, for the years ended December 31, 2001 and 2000 were $161 2 million and $65 2 million, respectively Data revenues as a percent of total revenues has increased from approximately 23% for the year ended December 31, 2000 to approximately 31% for the year ended December 31, 2001

During the year ended December 31, 2001, we acquired the stock of Adgrafix Corporation, an Internet-based, web hosting applications specialist based in the Boston area and Coast to Coast Telecommunications, Inc , a Detroit-based provider of local and long-distance telecommunications services We also acquired certain assets of HarvardNet, Inc., an Internet-based, web hosting applications specialist, and the assets of Intermedia Business Internet, a Tier I Internet service provider During the year ended December 31, 2000, we completed the acquisitions of CONNECTnet Internet Network Services, InterAccess Co , CTSnet and Jump Net, Inc , regional Internet service providers, and of Virtualis Systems, Inc , an Internet-based, web hosting applications specialist We have recognized the revenues earned since the closing of each of these acquisitions in our consolidated statement of operations for the years ended December 31, 2001 and 2000

Network Expenses

Year Ended December 31, 2002 compared with Year Ended December 31, 2001

For the years ended December 31, 2002 and 2001, network expenses were $404 4 million and $251 7 million, respectively, network expenses related to the Shared Technologies business included in the year ended December 31, 2002 were $47 9 million Network expenses as a percentage of total revenues increased from 49% for the year ended December 31, 2001 to 52% for the year ended December 31, 2002 The increase in network expense is consistent with the deployment of our networks and initiation and growth of our services during 2001 and 2002 While there can be no assurance that we will be successful in creating operating efficiencies, we expect to continue to control costs and that network expenses as a percentage of total revenues will reduce over time

Gross margin has decreased from 51% for the year ended December 31, 2001 to 48% for the year ended December 31, 2002 This decrease in gross margin was related to the lower margin contributed by our customer premise equipment sales and maintenance businesses, the loss of the Qwest managed modem port revenues when Qwest terminated its managed modem services contract with us in June 2002 and FCC-mandated decreases in interconnection revenues Gross margin is calculated as revenues less network expenses, divided by revenues We expect our gross margins to improve as our revenues increase and as we realize cost efficiencies in our network expenses

Network expenses include

- the cost of leasing local loop lines which connect our customers to our network;
- the cost of leasing high-capacity digital lines that interconnect our network and with the networks of the incumbent local exchange carriers,
- the cost of leasing high-capacity digital lines that connect our switching equipment to our transmission equipment located in the central offices of the incumbent local exchange carrier,
- the cost of expanding our network to additional colocation sites within a market,
- the cost of completing local, toll and long distance calls originated by our customers, including switched access and reciprocal compensation charges paid by us,
- the cost of leasing space in incumbent local exchange carrier central offices for colocating our transmission equipment,
- maintenance expenses for dark fiber,
- the cost of customer premise equipment which has been sold by us and the cost of providing maintenance services on such equipment,
- the cost of Internet transit and transport, and
- the cost of leasing certain portions of our nationwide Internet network

Network expenses do not include an allocation of our depreciation or amortization expenses

The costs to lease local loop lines, high-capacity digital T-1 loop lines, and high-capacity digital interoffice facilities from the incumbent local exchange carriers vary by carrier and by state and are regulated under the Telecommunications Act of 1996 In virtually all areas, we lease local loop lines and high-capacity digital T-1 loop lines from the incumbent local exchange carriers to connect our customers' premises to our transmission equipment colocated in the central offices of the incumbent carriers In the areas of low density and traffic in the metropolitan areas that we serve, we also depend on the incumbent local exchange carriers to provide us high-capacity digital interoffice facilities to connect our switch to our transmission equipment colocated in the incumbents' central offices In the areas of high density and traffic in our markets, in addition to the incumbent carriers, there are other carriers from whom we lease high-capacity digital interoffice facilities, we can generally lease those interoffice facilities at lower or comparable prices and with higher network reliability than those interoffice facilities provided by the incumbent local exchange carriers We have increasingly focused on obtaining these high capacity digital interoffice facilities on dedicated fiber Even in areas of high density and traffic in our markets, however, the incumbent local exchange carriers are sometimes the only available source of high-capacity digital interoffice facilities

We expect that our network costs will increase with customer volume and sales of our products and services and will be a significant part of our ongoing cost of services.

In accounting for the costs of constructing switching and transmission equipment for a new market, we capitalized as a component of property and equipment only the non-recurring charges associated with our initial network facilities

We incur "reciprocal compensation" costs in providing both voice and data services and expect reciprocal compensation costs to be a major portion of our cost of services We must enter into an interconnection agreement with the incumbent local exchange carrier in each market to make widespread calling available to our customers and these agreements are approved by the state regulatory agency These agreements typically set the cost per minute to be charged by each party for the calls that are exchanged between the two carriers' networks Generally, a carrier must compensate another carrier when a local call by the first carrier's customer terminates on the other carrier's network These reciprocal compensation costs are a variable cost that will grow as our customers' outbound calling volume grows Over time, the rates for reciprocal compensation have decreased and in some of our markets, we exchange local traffic with the incumbent local carrier on a bill-and-keep basis (which generally means that neither carrier pays for the traffic that moves across the other carrier's network) We also incur switched access charges for intrastate toll traffic we exchange with other carriers The rates for intrastate access traffic are regulated by state authorities and are usually contained in carriers' access tariffs

The cost of securing long distance service capacity is a variable cost that increases in direct relationship to increases in our customer base and increases in long distance calling volumes We believe that these costs, measured as a percentage of long distance revenues, will be relatively consistent from period to period However, we do expect period-over-period growth in the absolute cost of such capacity, and that the cost of long distance capacity will be a significant portion of our cost of long distance services

We install voice and data aggregation and switching equipment in space owned or leased by other parties, including locating our equipment in central offices of local incumbent exchange carriers' networks We incur rent and utility charges in leasing this space These costs will increase as we expand to additional colocation sites and increase the capacity of our existing colocations

We sell and install telecommunications customer premise equipment and provide maintenance services on such equipment Our costs to provide these products and services include both time and material costs These costs will increase or decrease in relation to the demand for these products and services

We have developed a national Internet data network by connecting our markets with leased high-capacity digital lines The costs of these lines will increase as we increase capacity to address customer demand and connect additional markets to our Internet network

We currently have a number of settlement-free peering arrangements with other Internet backbone providers Most of these arrangements are month-to-month and generally can be terminated by either party upon notice If we lose any of these arrangements or if the other Internet backbone provider requires payment by us for the exchange of traffic, our network costs may materially increase

Year Ended December 31, 2001 compared with Year Ended December 31, 2000

For the years ended December 31, 2001 and 2000, network expenses were $251 7 million and $150 7 million, respectively The increase in network expenses was consistent with the deployment of our networks and initiation and growth of our services during 2001 and 2000 Gross margin increased from approximately 47% for the year ended December 31, 2000 to approximately 51% for the year ended December 31, 2001

Selling, General and Administrative Expenses

Year Ended December 31, 2002 compared with Year Ended December 31, 2001

Selling, general and administrative expenses increased to $438 2 million for the year ended December 31, 2002 from $377 4 million for the year ended December 31, 2001, partially due to $26 9 million of selling, general and administrative expenses relating to the Shared Technologies business that we purchased in June 2002 Selling, general and administrative expenses as a percentage of total revenues decreased from 73% for fiscal year ended December 31, 2001 to 57% for fiscal year ended December 31, 2002 This decrease is partially due to an increase in our total revenues, our cost containment efforts (including a decrease in our headcount) and the achievement of certain economies of scale as we have grown the business Selling, general and administrative expenses include salaries and related personnel costs, administration and facilities costs, sales and marketing costs, customer care and billing costs, investor and media relations, insurance, professional fees and bad debt expense As a result of our transition from rapid revenue growth to a plan geared towards reducing cash used in operations and achieving positive cash flow, we reduced headcount, including the number of sales teams during the second half of 2002 Our total headcount decreased from 4,140 at December 31, 2001 to 3,814 at December 31, 2002 As of December 31, 2002, the sales force, including sales managers and sales administrators, had decreased to 1,118 from 1,584 as of December 31, 2001 Absent an acquisition, we expect selling, general and administrative expenses to decrease as a percentage of revenues as we focus on reducing cash used, integrating our operations and achieving economies of scale in our business

We are exposed to financially distressed telecom carriers, most notably WorldCom, Inc , which filed for bankruptcy protection on July 21, 2002 Selling, general and administrative expenses for the year ended December 31, 2002 include bad debt expenses totaling \$8 4 million, a majority of which is related to bad debt expense associated with exposure to WorldCom. We have significant set-off rights against WorldCom and are currently negotiating with WorldCom to resolve these set-off issues

Year Ended December 31, 2001 compared with Year Ended December 31, 2000

Selling, general and administrative expenses increased to \$377 4 million for the year ended December 31, 2001 from \$252 4 million for the year ended December 31, 2000, primarily due to headcount growth, the addition of nine new markets and growth of our customer base Selling, general and administrative expenses as a percentage of total revenues decreased from 88 5% for fiscal year ended December 31, 2000 to 73 0% for fiscal year ended December 31, 2001 The number of employees increased to 4,140 as of December 31, 2001, from 3,249 as of December 31, 2000 As of December 31, 2001, the sales force, including sales managers and sales administrators, had grown to 1,584 from 1,333 as of December 31, 2000

Depreciation

Year Ended December 31, 2002 compared with Year Ended December 31, 2001

During the years ended December 31, 2002 and 2001, depreciation expense was \$248 8 million and \$188 3 million, respectively Such increase was consistent with the continued deployment of our networks and initiation of services in new markets during 2001

Year Ended December 31, 2001 compared with Year Ended December 31, 2000

During the years ended December 31, 2001 and 2000, depreciation expense was \$188 3 million and \$104 2 million, respectively Such increase was consistent with the deployment of our networks and initiation of services in 36 markets by December 31, 2001

Amortization of Goodwill and Purchased Intangibles

Year Ended December 31, 2002 compared with Year Ended December 31, 2001

In connection with the acquisitions completed since inception, we assigned an aggregate of \$62 8 million of the purchase price to customer lists These intangible assets are being amortized over their estimated useful lives of one to three years. For the years ended December 31, 2002 and 2001, we recorded \$33 4 million and \$12 0 million of amortization of customer lists

On January 1, 2002, we adopted Statement of Financial Accounting Standards No 142, "Goodwill and Other Intangible Assets " SFAS 142 (1) requires that goodwill balances no longer be amortized and

(2) expands the classifications of other intangible assets and provides guidance for estimating the expected useful lives of these assets Prior to the adoption of SFAS 142, we recognized amortization on the goodwill recorded in connection with our business acquisitions The expense associated with amortization of goodwill in the year ended December 31, 2001 was $55 2 million Additionally, prior to the adoption of SFAS 142, we assigned an aggregate of $3 3 million to acquired workforces We recorded $1 2 million of amortization of these intangible assets during the year ended December 31, 2001 The acquired workforce intangibles are no longer being amortized and the net book value of these intangibles was reclassified as goodwill on January 1, 2002 upon the adoption of SFAS 142

We are required to periodically assess our goodwill for impairment under the provisions of SFAS No 142 We identified one reporting unit, as defined in SFAS No 142 As outlined in the authoritative literature, our assessment of whether our goodwill has been impaired is based on our estimate of the fair market value of the reporting unit using a model which considers both a discounted future cash flow analysis and market capitalization data Upon adoption of SFAS No 142 on January 1, 2002, our assessment did not indicate an impairment in our goodwill intangible However, during the six months ended June 30, 2002, our market capitalization remained at a level well below our book value As this decline in our market capitalization indicates that a potential reduction in the value of our goodwill exists, we performed an interim valuation as of June 30, 2002 using a valuation model which considers both a discounted future cash flow analysis and market capitalization data This valuation indicated that an impairment of our goodwill existed as of June 30, 2002 Accordingly, we recorded a charge of $114 7 million during 2002, reflecting the amount of impairment as of June 30, 2002 to eliminate our goodwill intangible

Our purchase price allocation for certain acquisitions made in 2002 is subject to post acquisition due diligence of the acquired entities and may be adjusted as additional information is obtained

Year Ended December 31, 2001 compared with Year Ended December 31, 2000

In connection with the acquisitions completed from inception through December 31, 2001, we assigned an aggregate of $62 8 million and $3 3 million of the purchase price to customer lists and acquired workforces, respectively We also recorded an aggregate of $190 7 million of goodwill Each of these intangible assets and goodwill acquired before June 30, 2001 was amortized over an estimated useful life of one to three years For the years ended December 31, 2001 and 2000, we recorded $55 2 million and $22 3 million of amortization for goodwill, $12 0 million and $4 0 million of amortization of customer lists and $1 2 million and $0 4 million of amortization of acquired workforces, respectively

Management Allocation Charges and Deferred Compensation Expenses

Year Ended December 31, 2002 compared with Year Ended December 31, 2001

We amortized $0 2 million of the deferred management ownership allocation charge, a non-cash charge to income, for year ended December 31, 2001 Our original private equity fund investors and original management team investors owned 95 0% and 5 0%, respectively, of the ownership interests of Allegiance Telecom, LLC, an entity that owned substantially all of our outstanding capital stock prior to our initial public offering of common stock As a result of that offering, the assets of Allegiance Telecom, LLC, which consisted almost entirely of such capital stock, were distributed to the original fund investors and management investors in accordance with the Allegiance Telecom, LLC limited liability company agreement This agreement provided that the equity allocation between the fund investors and management investors would be 66 7% and 33 3%, respectively, based upon the valuation implied by the initial public offering We recorded the increase in the assets of Allegiance Telecom, LLC allocated to the management investors as a $193 5 million increase in additional paid-in capital This transaction was recorded during the third quarter of 1998 Of this charge, we recorded

$122 5 million as a non-cash, non-recurring charge to operating expense and $71 0 million as a deferred management ownership allocation charge This deferred charge was fully amortized as of March 31, 2001

For the years ended December 31, 2002 and 2001, we recognized $2 7 million and $4 1 million, respectively, of amortization of deferred compensation expense Such deferred compensation was recorded in connection with membership units of Allegiance Telecom, LLC sold to certain management employees and grants of stock options and restricted common shares to certain employees under our 1997 stock option plan and 1998 stock incentive plan

Year Ended December 31, 2001 compared with Year Ended December 31, 2000

We amortized $0 2 million and $6 5 million of the deferred management ownership allocation charge, a non-cash charge to income, for the years ended December 31, 2001 and 2000, respectively During 2000, we repurchased 289,527 shares from terminated management employees, and reversed the remaining deferred charge of $0 1 million related to these shares to additional paid-in capital

For the years ended December 31, 2001 and 2000, we recognized $4 1 million and $10 1 million, respectively, of amortization of deferred compensation expense Such deferred compensation was recorded in connection with membership units of Allegiance Telecom, LLC sold to certain management employees and stock options granted to certain employees under our 1997 stock option plan and 1998 stock incentive plan

Interest Expense and Interest Income

Year Ended December 31, 2002 compared with Year Ended December 31, 2001

For the years ended December 31, 2002 and 2001, interest expense was $108.1 million and $74 3 million, respectively The increase in interest expense is primarily due to the interest expense associated with the draw down of $350 million and $135 3 million of our senior secured credit facilities in September 2001 and June 2002, respectively Interest expense reflects the accretion of the $11^3/_4$% notes and related amortization of the original issue discount, the amortization of the original issue discount on the $12^7/_8$% notes, and the interest charges and amortization of deferred debt issuance costs related to our $500 million senior secured credit facilities The amount of interest capitalized for the years ended December 31, 2002 and 2001 was $6.1 million and $16 9 million, respectively

Interest income for years ended December 31, 2002 and 2001 was $6 6 million and $15 7 million, respectively. Interest income results from short-term investments, cash and cash equivalents and from U S government securities, which we purchased and placed in a pledge account to secure the semi-annual payments of interest through May 2001 on the $12^7/_8$% notes Interest income during the year ended December 31, 2001 is greater than for the year ended December 31, 2002 because we had additional cash invested in interest-bearing instruments and because of higher average interest rates.

Year Ended December 31, 2001 compared with Year Ended December 31, 2000

For the years ended December 31, 2001 and 2000, interest expense was $74 3 million and $69 2 million, respectively The increase in interest expense is due to the interest expense associated with the draw down of $350 million of our senior secured credit facility in September 2001 Unamortized deferred debt issuance costs of $5 9 million related to the $225 million revolving credit facility were charged to interest expense during first quarter 2000, upon termination of the $225 million revolving credit facility and closing of our $500 million senior secured credit facilities The amount of interest capitalized for the years ended December 31, 2001 and 2000 was $16 9 million and $14 4 million, respectively

Interest income for years ended December 31, 2001 and 2000 was $15 7 million and $57 0 million, respectively Interest income during 2000 is greater than for the comparable periods in 2001 because we had additional cash invested in interest-bearing instruments as a result of our February 2000 equity offering Additionally, during 2001, we recorded impairment losses against interest income related to interest-bearing investment securities deemed to have a permanent decline in fair value

Operating Losses and Adjusted EBITDA Losses

Year Ended December 31, 2002 compared with Year Ended December 31, 2001

Our loss from operations for the years ended December 31, 2002 and 2001 was $471 2 million and $373 2 million, respectively

Management uses the measure of adjusted earnings before deducting interest, taxes, depreciation and amortization, also commonly referred to as "EBITDA" as a way of measuring the performance of our company In calculating adjusted EBITDA, we also exclude the recurring non-cash charges to operations for the management ownership allocation charge, deferred compensation expense, and goodwill impairment charges totaling $117 4 million and $4 3 million for the years ended December 31, 2002 and 2001, respectively For capital intensive businesses like ours, with high initial capital investments required prior to fully utilizing network assets with customer traffic, adjusted EBITDA is used by our management to monitor progress toward profitability from operations until adequate scale is achieved to realize positive operating income In addition, our free cash flow covenant in our amended senior credit agreement is based on the EBITDA metric and therefore is used by management to assess compliance with that covenant Adjusted EBITDA is not derived pursuant to generally accepted accounting principles, and therefore should not be construed as an alternative to operating income (loss), as an alternative to cash flows from operating activities, or as a measure of liquidity. EBITDA as used in this report may not be comparable to similarly titled measures reported by other companies due to definitional differences We had adjusted EBITDA losses of $71 6 million and $112 2 million for the years ended December 31, 2002 and 2001, respectively Below is a reconciliation between loss from operations and adjusted EBITDA

	Year Ended December 31,		
	2002	2001	2000
		(in millions)	
Loss from operations	$(471 2)	$(373 2)	$(265 3)
Less			
Depreciation and amortization	282 2	256 7	130 8
Non-cash deferred compensation	2 7	4 1	10 1
Management ownership allocation charge	—	0 2	6 5
Goodwill impairment charge	114 7	—	—
Adjusted EBITDA	$(71 6)	$(112 2)	$(117 9)

Year Ended December 31, 2001 compared with Year Ended December 31, 2000

Our loss from operations for the years ended December 31, 2001 and 2000 was $373 2 million and $265 3 million, respectively

We had adjusted EBITDA losses of $112 2 million and $117 9 million for years ended December 31, 2001 and 2000, respectively In calculating adjusted EBITDA, we also exclude the recurring non-cash charges to operations for the management ownership allocation charge and deferred compensation expense totaling $4 3 million and $16 6 million for the years ended December 31, 2001 and 2000, respectively

LIQUIDITY AND CAPITAL RESOURCES

As of December 31, 2002, we had approximately $284 3 million of unrestricted cash and short-term investments, compared with $399 3 million of unrestricted cash and short-term investments as of December 31, 2001 The 29% decrease from year-end 2001 to year-end 2002 is primarily due to the funding of our operating losses, interest payments on debt, capital expenditures, and working capital requirements, partially offset by proceeds from our draw of $135 3 million of the senior secured credit facilities in June 2002 and cash generated from investments

As of December 31, 2002 and December 31, 2001, we had approximately $1,201 2 million and $1,016 3 million of total indebtedness (including debt under our senior credit facilities, two series of bonds, and capital lease obligations) As discussed in more detail under the caption "Senior Secured Credit Agreement" below, on November 27, 2002, we entered into an amendment to our senior credit agreement that, among other things, requires us to reduce total indebtedness to no more than $645 million by April 30, 2003 If we cannot obtain a waiver from our senior lenders or reduce our debt as required, our senior lenders may request the immediate repayment of all outstanding amounts under our senior credit agreement $561 5 million and $3 1 million of our total indebtedness is included in current liabilities at December 31, 2002 and 2001, respectively We do not have any off-balance sheet financing arrangements, special purpose entities or asset securitizations

Our existing cash and short-term investment balances will decline further during fiscal 2003 Historically, our financing plan has been predicated on the pre-funding of each market's expansion to positive free cash flow Given the continued poor economic environment as well as the instability and bankruptcies of customers and others in the telecom industry and their subsequent negative impact on our performance in 2002, however, we no longer believe that we have raised the capital necessary to build and operate our network in each of our 36 markets to the point at which operating cash flow from the market is sufficient to fund its ongoing operating costs and capital expenditures If our revenue, line churn and other financial forecasts prove to be accurate, we believe our cash on hand will be sufficient to fully fund our operations, planned capital investments and debt service for approximately 18 to 24 months As a result, as described below, we have agreed under the terms of an amendment to our senior credit agreement, to reduce our debt from current levels to no more than $645 million by April 30, 2003 A reduction to this level, however, may still be insufficient to fully fund our operations, planned capital investments and debt service even if we do achieve our current forecasts and financial plans Thus, we are considering a potential further reduction in our debt as part of our recapitalization and/or a material modification to the amortization schedule for our senior secured debt One result of any such recapitalization would be a substantial reduction in the value of our high yield debt securities and common stock, potentially to zero Please see the discussion below under the caption "Senior Secured Credit Agreement" and above under the caption "Risk Factors "

We cannot assure you that our current estimates for required funding are accurate We may need to seek additional capital in the future to refinance some of our existing debt and/or expand our business Sources of additional financing may include vendor financing, bank financing and/or the private or public sale of our equity or debt securities We cannot assure you, however, that such financing will be available at all or on terms acceptable to us, or that our estimate of additional funds required is accurate Our common stock closed at $0 34 on March 26, 2003, with our stock trading at these levels, it is unlikely that we will be able to seek funding from the public equity markets In addition, in light of adverse developments in the general economy and specifically the telecommunications industry, it may be extremely difficult to obtain vendor financing, bank financing or other public/private funding necessary to continue funding our business The actual amount and timing of future capital requirements may differ materially from our estimates as a result of, among other things

- the cost of the development and operation of our networks in each of our markets,

- a change in or inaccuracy of our development plans or projections,
- the extent of price and service competition for telecommunications services in our markets,
- the demand for our services and rate of line churn,
- regulatory and technological developments, including additional market developments, price changes and availability of network elements and new opportunities in our industry,
- an inability to borrow under our senior credit facilities or the inability to meet the financial or other covenants contained in our senior credit facilities,
- our ability to continue to achieve economies of scale in selling, general and administrative expenses,
- the general economy, and
- the consummation of acquisitions

Our cost of rolling out our networks and operating our business, as well as our revenues, will depend on a variety of factors, including

- our ability to meet our roll-out and Internet backbone migration schedules,
- the ability of our suppliers to provide the facilities, equipment and services in accordance with our schedule,
- our ability to negotiate favorable prices for purchases of facilities, equipment and services,
- our ability to develop, acquire and integrate the necessary operations support systems and other back office systems,
- the number of customers, the services for which they subscribe and customer churn,
- the nature and penetration of new services that we may offer,
- our ability to integrate our acquisitions,
- the impact of changes in technology and telecommunication regulations

As such, actual costs and revenues may vary from expected amounts, possibly to a material degree, and such variations are likely to affect our future capital requirements Decreased demand for our services or high customer churn, as noted above, could adversely impact our liquidity Customer demand for our services depends in part on our ability to efficiently and timely switch customers from their prior carrier to our service, respond to customer service and billing issues and provide quality service

Our financial projections are based on forecasts of, among other things, customer demand and line churn, i e the rate at which customers discontinue their lines Customers leave our service for a variety of reasons, including but not limited to, the customer (a) leaving our service area, (b) going out of business or downsizing its business, (c) being unhappy with our service, (d) general market conditions, (e) leaving for better pricing, and (f) needing a different telecom solution that we do not provide

In the fourth quarter 2002, the average retail line churn was 4 1% and including wholesale, our average line churn was 2 6%. Line churn is the number of voice grade equivalent lines (for example, a fully-utilized data T-1 counts as 24 lines) that are disconnected each month divided by the total number of voice grade equivalent lines that we have in service at the beginning of that month The line churn is difficult to forecast and remains one of the specific challenges that we are focused on We expect that retail line churn as well as retail and wholesale line churn will range between 2% to 3% in 2003 We expect retail and wholesale line churn to improve in 2004 and beyond We have responded to high line churn with many customer retention initiatives including, back office improvements, roll out of Singl eView billing system, proactive contact with customers, and root cause resolutions The above churn metrics do not include churn related to businesses such as Shared Technologies, Allegiance Business Internet access services, wholesale, or web hosting We can provide no assurances that we will be able to effectively manage or reduce our line churn If we are unable to do so, this will materially affect our business, revenues and liquidity

Decreased customer demand may also stem from uncertainty of the industry in which we compete and the general economy Many of our competitors have declared bankruptcy, de-listed from the public securities markets and/or identified financing problems Some of our potential customers as well as current customers have expressed concerns about our financial stability in light of the general economy and the telecommunications industry in general We believe customer perception will continue to have an impact on our ability to attract and retain customers Moreover, our customers may not purchase additional services and may cancel existing services as a result of general economic conditions or our specific financial condition, including the independent auditors' report for 2002 that cites conditions which raise substantial doubt about our ability to continue as a going concern

For the years ended December 31, 2002 and 2001, we made capital expenditures of $129 9 million and $364 4 million, respectively As of December 31, 2002, we had transmission equipment colocated in 849 central offices Pursuant to our business plan, we expect to use approximately $50 million to $60 million for capital expenditures in 2003 We expect to fund our capital expenditures with available cash and future cash flow

In April 2000, we executed a master procurement agreement with Lucent Technologies Inc for a broad range of advanced telecommunications equipment, software and services This agreement contains a three-year $350 million purchase commitment In July 2001, we amended this agreement to extend the term to six years Under the amended agreement, we must complete purchases totaling $100 million by December 31, 2000, an aggregate of $160 million of purchases by September 30, 2001, an aggregate of $210 million by December 31, 2002, an aggregate of $257 million by December 31, 2003, an aggregate of $304 million by December 31, 2004, and the full $350 million of aggregate purchases on or before December 31, 2005 In 2002, Lucent waived $50 million of the $210 million purchase commitment for 2002 in exchange for a purchase commitment by us of approximately $13 1 million of telecom equipment We purchased the $13 1 million of telecommunications equipment and have satisfied the purchase commitment for 2002 As of December 31, 2002, the remaining commitment under this agreement is approximately $123 8 million The agreement provides that, subject to certain conditions, if we do not meet the required purchase milestones, we will be required to provide cash settlement in an amount equal to the shortfall During the term of the contract, such shortfall payments may be applied to future purchases in the next succeeding year Given the change in focus in our business to achieving profitability, we are in the process of renegotiating this contract with Lucent There can be no assurance that we will be successful in renegotiating this contract Our agreement with Lucent is publicly available in our filings with the SEC and should be reviewed in its entirety to gain a full understanding of its terms

We have purchased dedicated fiber rings in 24 of our markets As of December 31, 2002, we had dedicated fiber rings in operation in 24 markets including Austin, Baltimore, Boston, Chicago, Dallas, Denver, Detroit, Ft Worth, Houston, Long Island, Los Angeles, New York City, Northern New Jersey, Philadelphia, Phoenix, Pittsburgh, Portland, San Antonio, San Diego, San Francisco, St Louis, Seattle, Washington, D C , and White Plains We have also acquired long-haul point to point fiber connectivity between several markets in the northeast corridor Our cost of fiber includes both the amounts we pay to the fiber provider as well as the cost of the electronic equipment that we purchase and install to make the fiber operational As of December 31, 2002, our total costs have been $150 7 million, and we are committed to spend an additional $157 5 million for this fiber, which will be incurred over the life of these existing fiber supply arrangements ending in 2022 We plan to fund this cost with our available cash and future cash flow

Contractual Obligations

The following summarizes some of our future financial commitments at December 31, 2002 and the effect such obligations are expected to have on our liquidity and cash flow in future periods

Contractual Obligations	Total	Payments due by Period Less than 1 year	1 to 3 years	3 to 5 years	After 5 Years
			(dollars in millions)		
Long-term debt(1)(2)					
Principal payments	$1,120	$556	$228	$242	$94
Interest payments	479	79	198	163	39
Capital lease obligations, including interest(3)	172	14	26	23	109
Operating leases	204	31	56	49	68
Other material long-term obligations(3)	137	39	98	—	—
Total contractual cash obligations	$2,112	$719	$606	$477	$310

(1) Long-term debt consists of our $11^{3}/_{4}$% senior notes, $12^{7}/_{8}$% senior notes and our senior secured credit facilities As discussed in more detail below, under our senior credit agreement, we are required to reduce our total outstanding debt to a level not exceeding $645 million on or before April 30, 2003 The "less than 1 year" column includes the amount of debt that is required to be reduced by April 30, 2003 However, interest payments outlined in the above table do not take into account any such debt reduction, as the specific components and amounts are not yet known Instead, interest payments include all scheduled interest payments assuming all debt remains outstanding until its original contracted amortization or maturity date.

(2) As discussed in more detail below, a default under our senior credit agreement or our indentures could cause the debt under these financing arrangements to become immediately due and payable In addition, in the event of a change of control, as defined in our indentures, we will be required to make an offer to repurchase all of our $12^{7}/_{8}$% senior notes and $11^{3}/_{4}$% senior notes at a purchase price equal to 101% of the aggregate principal amount thereof and 101% of their accreted value, respectively, together with accrued and unpaid interest thereon, to the date of repurchase A change of control, as defined in our senior credit agreement, could cause the debt under that agreement to become immediately due and payable. No adjustment that might result from the potential impact of these acceleration events is reflected in this table

(3) Does not include future obligations that may arise under purchase orders, since delivery of services under those purchase orders has not been made

Historical Financing Activities

On February 28, 2000, a three-for-two stock split of our common stock was effected in the form of a 50% dividend to shareholders of record on February 18, 2000 All references to the number of common shares and per share amounts have been restated to reflect the stock split for the periods presented

On February 3, 1998, we raised gross proceeds of approximately $250 5 million in an offering of 445,000 units, each unit consisting of one $11^{3}/_{4}$% senior discount note and one redeemable warrant Net proceeds of approximately $240 7 million were received from that offering The $11^{3}/_{4}$% notes have a principal amount at maturity of $445 0 million and an effective interest rate of 12 21% The $11^{3}/_{4}\%$ notes are unsecured and mature on February 15, 2008 Commencing August 15, 2003, interest on such notes is payable in cash at the rate of $11^{3}/_{4}\%$ per annum on February 15 and August 15 of each year The accretion of original issue discount will cause an increase in indebtedness from December 31, 2002 to February 15, 2003 of $11 0 million

We completed the initial public offering of our common stock and the offering of the $12^{7}/_{8}\%$ senior discount notes early in the third quarter of 1998 We raised net proceeds of approximately $137 8 million from our initial public offering of common stock and approximately $124 8 million in our offering of the $12^{7}/_{8}\%$ senior discount notes The $12^{7}/_{8}\%$ notes are unsecured and mature on May 15, 2008 Interest on these notes is payable in cash on May 15 and November 15 each year, commencing November 15, 1998 The $12^{7}/_{8}\%$ notes were sold at less than par, resulting in an effective rate of 13 24%, and the value of the $12^{7}/_{8}\%$ notes is being accreted, using the effective interest method, from the $200 9 million gross proceeds realized at the time of the sale to the aggregate value at maturity, $205 0 million, over the period ending May 15, 2008 The accretion of original issue discount will cause an increase in indebtedness from December 31, 2002 to May 15, 2008 of $2 8 million

On April 20, 1999, we completed the public offering of 17,739,000 shares of our common stock at a price of $25 33 per share, raising gross proceeds of $449 4 million After underwriters' fees and other expenses, we realized net proceeds of approximately $430 3 million On April 28, 1999, the underwriters of this offering exercised an option to purchase an additional 3,302,100 shares of common stock at the same price per share As a result, we raised an additional $83 6 million of gross proceeds and $80 3 million of net proceeds, at that time

On February 2, 2000, we completed the public offering of 9,900,000 shares of our common stock at a price of $70 00 per share, raising gross proceeds of $693 0 million After underwriters' fees and other expenses, we realized net proceeds of approximately $665 6 million On February 29, 2000, the underwriters of this offering exercised an option to purchase an additional 803,109 shares of common stock at the same price per share As a result, we raised an additional $56 2 million of gross proceeds and $54 1 million of net proceeds

Senior Secured Credit Agreement

In February 2000, we closed on $500 0 million of new senior secured credit facilities, which replaced our prior $225 million revolving credit facility These new senior secured credit facilities consist of a $350 0 million revolving credit facility and a $150 0 million delayed draw term loan facility Interest on amounts drawn is generally the 6-month London Interbank Offered Rate plus 4.50% per annum Our senior lenders have a security interest in (1) the capital stock of Allegiance Telecom Company Worldwide (which stock is owned by our parent holding company, Allegiance Telecom, Inc) and (2) all of the assets of Allegiance Telecom Company Worldwide, including the capital stock owned by that entity in each of its subsidiaries

During the third quarter of 2001, we drew $200 0 million under the revolving credit facility and $150 0 million under the delayed draw term loan The interest rate applicable to this draw is 5 72% per annum and will remain fixed until September 18, 2003, then it will be adjusted based on the London Interbank Offered Rate in effect at that time In June 2002, we requested a draw of the remaining $150 million under the revolving credit facility As of December 31, 2002, we had received $135 3 million of the $150 million, with 3 of the 26 banks in the bank syndicate refusing to fund our request We believe that these 3 banks are in default of the credit agreement and have notified them accordingly We have worked with these 3 banks to resolve this dispute amicably by providing additional information, but we can provide no assurances that we will be able to resolve this dispute Thus, we may need to pursue our claims against them in court in an effort to obtain the additional $14 7 million that we believe should have been funded in June 2002 under the terms of our credit agreement The interest rate applicable to this draw is 5 90% per annum and will remain fixed until

June 26, 2003, then it will be adjusted based on the London Interbank Offered Rate in effect at that time.

Our credit agreement contains certain representations, warranties and covenants, including many financial covenants The revolving credit facility must be permanently repaid in accordance with its amortization schedule as follows 20% in 2004 (a pro-rata amount each quarter), 30% in 2005 (a pro-rata amount each quarter) and 50% in 2006 (a pro-rata amount each quarter) Principal amounts of the delayed draw term loan are to be repaid as follows 20% in 2004 (pro-rata payments to be made quarterly), 30% in 2005 (pro-rata payments to be made quarterly) and 50% in 2006 (pro-rata payments to be made quarterly) Our credit agreement (including our financial covenant schedules), as amended and indentures are publicly available in our filings with the Securities and Exchange Commission and should be reviewed in their entirety to gain a full understanding of the covenants and other requirements applicable to us under those documents

On November 27, 2002, we announced that we had entered into an interim amendment with our senior bank creditors regarding modifications to our $500 million senior secured credit facility Under this interim amendment, we obtained a waiver of all existing financial covenants through April 30, 2003 and replaced those covenants during this period with a free cash flow from operations covenant (EBITDA less capital expenditures) and a total leverage covenant Under this interim amendment, we cannot permit our consolidated total debt to exceed at any time (i) $1 275 billion from November 27, 2002 through April 29, 2003 and (ii) $645 million thereafter Under the terms of the interim amendment, we repaid $15 million of the credit facility, which was applied to the 2004 amortization According to the terms of this amendment, we cannot permit free cash flow from operations (EBITDA less capital expenditures) to be less than $(34) million in the fourth quarter of 2002 or less than $(19) million in the first quarter of 2003 We met this covenant with respect to the fourth quarter of 2002

We are currently negotiating with our senior lenders (and other parties in interest, including our bondholders) to address the requirements in this amendment to our senior credit agreement and to agree upon an overall capital structure that is feasible and in the best interests of the company on both a short term and long term basis To reduce our debt, we or our affiliates may from time to time purchase such debt for cash, exchange them for our common stock and/or another debt or equity security or acquire such debt for a combination of cash and common stock and/or another debt or equity security, in each case in open market purchases, in privately negotiated transactions, through exchange offers or in a negotiated or prepackaged bankruptcy proceeding We are currently evaluating such transactions and other potential recapitalization plans in light of the requirements under our senior credit agreement, existing market conditions, current and projected liquidity, other contractual restrictions, current and projected operating performance and other factors The amount of cash used, debt incurred or securities issued in any such transactions, individually or in the aggregate, may be material as well as the related dilution to common stockholders If we cannot reduce our debt to the required levels by April 30, 2003 or enter into an amendment or obtain a waiver, we will be in default under our senior credit agreement In addition, if we do not enter into a permanent amendment to our senior credit agreement before May 1, 2003, or enter into an amendment or obtain a waiver, we will be in default under that agreement. If any such default occurs, our senior lenders would have the right to request immediate repayment of our senior debt, in which case, our bondholders would then have the right to request immediate repayment of our bonds If any of these events occur, this would have a material adverse effect on us and may result in a foreclosure proceeding or a voluntary or involuntary bankruptcy filing We may also determine, based on the factors listed above as well as the terms and conditions of any proposed recapitalization, that it would be advisable to reduce our debt to a greater extent than that required by the interim amendment to our senior credit agreement This determination would involve a reduction in our senior secured debt and any such reduction would substantially reduce the value of our other debt securities and our common stock, potentially to zero

Under the terms of our senior credit agreement, we are required to deliver an unqualified audit report to our senior lenders We received an audit report that is modified to express substantial doubt about our ability to continue as a going concern As such, if we do not receive a waiver from our senior lenders or if we are unable to cure this breach within 30 days, there will be an event of default under our senior credit agreement As discussed above, we will be in default on April 30, 2003 in any event if we have not reduced our debt as required and we would be in default on the following day if we have not entered into a permanent amendment to our credit agreement

Our failure to comply with the covenants discussed above and restrictions contained in our financing agreements could lead to default under the terms of these agreements If an event of default exists under our senior credit agreement, our lenders could declare all amounts borrowed immediately due and payable and terminate their commitments to lend to us In addition, if our senior lenders under our senior credit agreement accelerate the repayment of our senior debt, our bondholders may also accelerate the repayment of our bonds under our indentures If any of these events occur, we cannot assure you that we would be able to make payments on our indebtedness, meet our working capital or meet our capital expenditure requirements, or that we would be able to find additional alternative financing

EMPLOYEE EQUITY INCENTIVES

As an emerging growth company focused on achieving positive earnings from operations, we rely more on equity incentive compensation than on cash compensation to attract and retain talented employees, especially at our senior executive level For example, based on an independent compensation study done for our Compensation Committee, Royce Holland, our Chairman and Chief Executive Officer, and Dan Yost, our President and Chief Operating Officer, received cash compensation in 2002 materially below the median cash compensation levels paid to executives in comparable positions at comparable companies In 2002, we shifted most of our equity compensation of senior executives to restricted stock rather than stock options The value of restricted stock on the date of grant is recognized as compensation expense for accounting purposes over the vesting term of the restricted stock award All of the unvested equity incentives for our CEO, President and CFO are now in the form of restricted stock Thus, the value of all of the equity incentives provided to them is recorded as compensation expense in our financial statements

Our equity incentive program is broad-based with substantially all of our employees participating Of our total stock options outstanding as of December 31, 2002, over 75% are held by employees below the rank of vice president All equity grants to senior executives are made after a review by, and with the approval of, the compensation committee of the board of directors. See the "Report of the Compensation Committee on Executive Compensation" appearing in our proxy statement for our 2003 annual meeting of stockholders for further information concerning the use of equity incentives

CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America The preparation of these consolidated financial statements requires us to make estimates and assumptions about the effect of matters that are inherently uncertain These estimates and assumptions affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities that exist at the date of our consolidated financial statements While we believe our estimates are appropriate, actual results can, and often do, differ from those estimates

Our critical accounting policies are discussed below Each of these areas involves complex situations and a high degree of judgment either in the application and interpretation of existing literature or in the development of estimates that impact our financial statements

Revenue Recognition. We recognize revenues as we provide services to our customers Our revenue recognition policies are designed to comply with all applicable accounting principles generally accepted in the United States of America, including SEC Staff Accounting Bulletin No 101, "Revenue Recognition in Financial Statements" ("SAB 101"), which provides additional guidance on revenue recognition as well as criteria for when revenue is realized and earned and related costs are incurred The application of SAB 101 requires management's judgment on the amount and timing of revenue recognition Should changes in conditions cause management to determine the revenue recognition criteria are not met for certain future transactions, revenue recognized for any reporting period could be adversely affected

The assessment of collectibility is particularly critical in determining whether or not revenue should be recognized A portion of our revenues is for reciprocal compensation generated by calls placed to Internet service providers who are our customers In addition, a portion of our revenues is switched access charge revenue for connecting our voice customers to their selected toll or long distance carriers for outbound calls or for delivering inbound toll and long distance traffic to our voice customers. Our ability to earn reciprocal compensation revenues and switched access revenues as well as the rates is the subject of numerous regulatory and legal challenges Until these issues are ultimately resolved, our policy is to recognize these revenues only when realization is probable

***Accounts* Receivable.** A considerable amount of judgment is required in assessing the ultimate realization of our accounts receivable We evaluate the collectibility of our accounts receivable based on a combination of factors We recognize allowances for doubtful accounts based on the length of time the receivables are past due, the current business environment and our historical experience In circumstances where we are aware of a specific customer's or carrier's inability to meet its financial obligations to us, we record a specific allowance against amounts due, to reduce the net recognized receivable to the amount we reasonably believe will be collected

Some of our customers and interconnection carriers have sought bankruptcy protection, which has resulted in an increase in our allowance for doubtful accounts For customers who have filed for bankruptcy, our policy is to fully reserve outstanding receivables for services provided in periods prior to their bankruptcy filing If the financial condition of our customers and/or interconnection carriers were to deteriorate further or if economic conditions worsened, additional allowances may be required in the future

Network Expenses. We recognize network expenses as the products and services are provided to us by our vendors The recognition of network expense and the related liabilities for network expense requires certain estimates and assumptions to be made by management. Our accruals for unbilled leased network facilities, network access charges, and equipment colocation charges are based on line counts, estimated usage, and active colocation sites Additionally, our accrual includes charges invoiced by network providers which are probable network expenses but have not yet been paid due to disputes with these carriers Should changes in conditions or facts cause us to revise our estimates, our financial condition and results of operations could be significantly impacted

Impairment of Long-Lived Assets. We review the carrying values of property and equipment and intangible assets for impairment in accordance with Statement of Financial Accounting Standards No 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144") Under SFAS 144, we are required to identify current events or changes in circumstances which indicate that the carrying amount of an asset may not be recoverable If impairment indicators are present, we analyze the projected undiscounted cash flows associated with our property and equipment and intangible assets to determine the fair value of these assets Considerable management judgment is necessary in establishing the assumptions used as a basis for this analysis.

Our continuing losses from operations is one potential indicator that the carrying value of certain of our assets may not represent their fair value We performed an analysis comparing estimated future cash flows to the carrying value of our property and equipment and intangible assets at December 31, 2002 This analysis did not indicate that an impairment exists as of December 31, 2002 Although we believe our estimates and assumptions used in this calculation are reasonable, actual results could vary significantly from these estimates Should changes in conditions or facts cause us to revise our estimates, we could be required to record impairment charges in future periods, which may have a significant impact on our results of operations

Other Matters. We do not have any of the following

- Off-balance sheet financial arrangements
- Trading activities that include non-exchange traded contracts accounted for at fair value

Management has discussed the development and selection of these critical accounting estimates with the audit committee of our board of directors, and the audit committee has reviewed our disclosure relating to them

NEW ACCOUNTING PRONOUNCEMENTS

We continually monitor and revise our accounting policies as developments occur The following recently issued accounting pronouncements may impact the future presentation of our financial condition and results of operations

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No 143, "Accounting for Asset Retirement Obligations " This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs Our adoption of this statement did not have a material effect on our financial position or results of operations

In August 2001, the Financial Accounting Standards Board also issued Statement of Financial Accounting Standards No 144, "Accounting for the Impairment or Disposal of Long-Lived Assets " This Statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets Adoption of this statement is required for fiscal years beginning after December 15, 2001 Our adoption of this statement did not have a material effect on our financial position or results of operations

In June 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No 146, "Accounting for Costs Associated with Exit or Disposal Activities " This statement addresses financial accounting and reporting for costs associated with exit or disposal activities Adoption of this statement is required for exit or disposal activities initiated after December 31, 2002, with early application encouraged Our adoption of this statement is not expected to have a material effect on our financial position or results of operations

In December 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No 148, "Accounting for Stock Based Compensation-Transition and Disclosure " This statement provides alternative methods of transition to entities that adopt the fair value method of accounting for stock-based employee compensation We have elected to continue to apply the provisions of Accounting Principles Board Opinion No 25, "Accounting for Stock Issued to Employees" to account for stock based compensation The statement requires expanded disclosure of pro-forma fair value stock compensation information for all companies regardless of whether an entity adopts the fair value method of accounting for stock based compensation These disclosures are generally required for fiscal years ending after December 15, 2002 and have been included in the notes to our consolidated financial statements

CERTAIN RELATED PARTY TRANSACTIONS

In connection with the employment of G Clay Myers, our Senior Vice President of Finance and Accounting, Mr Myers borrowed $250,000 from us on December 6, 1999 Mr Myers issued a promissory note payable to Allegiance for this amount, which note was payable on December 6, 2002 Such note accrued interest at 5 74% per annum, which was the December 1999 applicable federal rate The $250,000 was used by Mr Myers to replace certain benefits he had to forego from his prior employer upon his acceptance of a position with Allegiance Mr Myers repaid this note in full in March 2003

On April 4, 2001, Anthony Parella, a Director and our President of Telecom and Retail Services, borrowed $3 0 million from us Mr Parella issued a promissory note payable to us, which note was payable on April 4, 2004 In September 2001, Mr Parella borrowed an additional $1 2 million from us Mr Parella issued a full recourse promissory note (the "Full Recourse Note") payable to us for a total amount of $4 2 million plus previously accrued interest of $81,564 on the April 4, 2001 note The Full Recourse Note is payable on April 4, 2004 This note accrues interest at 2 73% per annum, which was the November 2001 applicable federal rate, and interest is payable when this note is due In the event Mr Parella resigns or is terminated by us for cause (as defined in the Full Recourse Note), then this note will become immediately due and payable Under the Full Recourse Note, we have the right to enforce the repayment obligation of Mr Parella by looking to his personal assets The Full Recourse Note is also secured by a pledge of Mr Parella's Allegiance stock options, as well as 350,000 shares of Allegiance common stock The $4 2 million was used by Mr Parella to repay certain debt that he incurred in connection with the purchase of land That debt was secured by Mr Parella's Allegiance stock and he would have been forced to sell such stock to satisfy the debt if he did not obtain another means of repaying the debt We determined that making the loan to Mr Parella was in the best interests of our stockholders because it allowed him to avoid a forced sale of his shares and instead be able to take the time necessary to sell his land

The loans to Mr Myers and Mr Parella are reflected in "other current assets" and "other long-term assets", respectively, in our financial statements If Mr Parella does not repay his loan under the terms of his note, we will have recourse to his Allegiance stock options, shares of Allegiance common stock and personal recourse

In fiscal 2002, Swidler Berlin Shereff Friedman, LLP performed legal services for us Andrew Lipman, a member of our board of directors, is a senior partner at this law firm We incurred approximately $450,000 in legal fees by this firm in 2002. We intend to continue using this law firm in fiscal 2003 for advice on legal matters

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our investment policy is limited by our existing bond indentures and senior credit agreement We are restricted to investing in financial instruments with a maturity of one year or less The indentures require investments in high quality instruments, such as obligations of the U S government or any agency thereof guaranteed by the United States of America, money market deposits and commercial paper with a rating of A1/P1

We are thus exposed to market risk related to changes in short-term U S interest rates We manage these risks by closely monitoring market rates and the duration of our investments We do not enter into financial or commodity investments for speculation or trading purposes and are not a party to any financial or commodity derivatives

Interest income earned on our investment portfolio is affected by changes in short-term interest rates We believe that we are not exposed to significant changes in fair value because of our conservative investment strategy. However, the estimated interest income for 2003, based on the estimated average 2002 earned rate on investments, is $3 0 million Assuming a 100-basis-point drop in the estimated average rate, we would be exposed to a $2 0 million reduction in interest income for the year The following table illustrates this impact on a quarterly basis

	Quarter Ending				
	March 2003	June 2003	September 2003	December 2003	Total
			(dollars in millions)		
Estimated average investments	249 8	209 6	194 7	175 4	
Estimated average interest earned at the average rate of 1 44% for the year ended December 31, 2002	0 9	0 8	0 7	0 6	3 0
Estimated impact of interest rate drop	0 69	0 5	0 5	0 4	2 0

Our outstanding long-term debt consists both of long-term, fixed rate notes, not subject to interest rate fluctuations, and our senior secured credit facilities Borrowings under our senior secured credit facilities incur interest at a variable rate, based on leverage ratios, and is currently the London Interbank Offered Rate plus 4 50% Our blended borrowing rate, taking new borrowings into account, is now 5 77% per annum and this interest rate will remain fixed until June 26, 2003 Therefore, we will not be exposed to market risk related to rate fluctuations during the first two quarters of 2003

Beginning in June 2003, we will be exposed to market risk related to market changes in the London Interbank Offered Rate and other market indexes Based on our current level of debt, the impact of a 100-basis-point increase in our average interest rate would cause an increase in interest expense during 2003 of $1 7 million

ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The information required by this Item 8 is included in pages F-1 through F-26 of this report

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

On June 7, 2002, we reported in a Form 8-K that our audit committee of the board of directors unanimously approved the appointment of KPMG LLP as the independent accountants of our company for the fiscal year ending December 31, 2002, replacing Arthur Andersen LLP We formally terminated our relationship with Arthur Andersen and engaged KPMG LLP as our independent accountants on May 31, 2002

The audit reports of Arthur Andersen on the consolidated financial statements of our company as of and for the years ended December 31, 2001 and 2000, did not contain any adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope, or accounting principles In connection with the audits of the two fiscal years ended December 31, 2001 and 2000 and during the subsequent interim period through June 7, 2002, there were no disagreements with Arthur Andersen on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures, which disagreements if not resolved to their satisfaction would have caused them to make reference in connection with their opinion to the subject matter of the disagreement Attached as Exhibit 16 to our Form 8-K filed with the SEC on June 7, 2002 is a copy of Arthur Andersen's letter, dated June 7, 2002, stating its agreement with those statements

During the two fiscal years ended December 31, 2001 and 2000 and through the subsequent interim period through June 7, 2002, we did not engage KPMG LLP with respect to the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on our consolidated financial statements, or any other matters or reportable events as set forth in Items 304(a)(2)(i) or (ii) of Regulation S-K